THE UNTOLD STORY OF CHINESE BANKING AND WHY IT MATTERS

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IN MID-2022, thousands of angry depositors stormed the Henan office of the central bank of the People's Republic of China (PRC). The cause was a classic bank-run trigger: people were unable to retrieve their deposits from some of the lesser-known village and township banks 村镇银行 that rarely feature in discussions of China's financial system. Many of the depositors/protesters were from outside Henan province; a substantial number had travelled thousands of kilometres from Guangdong province to join the rally. Clearly, the banks in humble Henan province had managed to attract depositors nationwide. Who were these village and township banks? How did they manage to draw deposits from so far afield? And why were they underregulated to the point of generating unrest? What happened in Henan was hardly unique. Indeed, it could be the beginning of a much bigger challenge with which China's new economic management team will have to grapple carefully but resolutely into the future. The root cause of the Henan crisis lies in the kind of market that the Communist Party of China (CPC) has cultivated in the world's largest banking system (the assets of which are equal to 40 percent of global gross domestic

product), particularly since the mid-1990s. I call it a 'state-owned market system'. This market has a Leninist foundation, its organisation mirrors that of the party-state, and the incentives for market competition go far beyond economic profits. It is a system in which market and administrative financial allocations coexist, party discipline and market discipline both matter, and profits and politics reign in uneasy tandem.

The Grand Bargain

Most China watchers know that the country's banking system is firmly controlled by the party-state. Yet, state control has not precluded market diversification and competition. The stereotypical view of Chinese banking, based on the early reform years, sees a system dominated by the Big Four banks: the Industrial and Commercial Bank of China, the China Construction Bank, the Bank of China, and the Agricultural Bank of China. This picture is obsolete and analytically misleading. While the Big Four once controlled almost all banking assets in China, their asset share has now dwindled to less than 25 percent — a dramatic transformation.

What happened, though, was hardly a liberalisation of the sector. Private and foreign banks still play a negligible role in the Chinese system. Instead, underlying the shrinking market share of the Big Four is the proliferation of banks owned or controlled by lower-level governments, which I term 'local state banks' (for example, the Shanghai Bank, Beijing Bank, and Baoshang Bank). Since the mid-1990s, these banks have proliferated exponentially, numbering more than 2,000 by the mid 2010s. While the Big Four remain the largest players in the system, in many localities, they have lost their market dominance to the local state banks.[1]

The rise of the local state banks was never simply a story of market reform, i.e., it was never about supporting underfunded private firms and small businessowners in the first place. In fact, it was the outcome of a 'grand bargain', a political quid pro quo.[2] Throughout the 1980s and early 1990s, a decentralised fiscal system incentivised China's local governments to pursue economic development. Unlike the Mao Zedong era, when all revenue had to be handed over to the central

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government, local governments could keep the remainder after sharing with the central government a prescribed amount of taxes. However, by the early 1990s, localities were amassing almost 80 percent of the country's total revenue. Beijing worried that this high degree of fiscal decentralisation could sow the seeds of political disintegration, as had occurred in the former Yugoslavia. So, the central government decided to take a large chunk of revenue away from the localities — that is, to recentralise. From 1993 to 1994, the central government's share of revenue increased dramatically, from about 20 to 55 percent. However, Beijing did not achieve this through blunt administrative fiat. To keep localities happy and ensure they remained incentivised to pursue local development, the centre compensated them. It helped localities meet their responsibilities after recentralisation through fiscal transfers and tax returns and permitted them to organise local government financing vehicles (LGFVs) to borrow and sell land to real estate developers.

Less well known is the most crucial component of Beijing's offer: allowing local governments to enter banking. Beijing even promised to

assist by transferring some central financial assets to help kickstart local banks. Vice-premier Zhu Rongji repeatedly highlighted the possibility of allowing localities to organise their own banks when negotiating the details of recentralisation with the localities.

Herein lies the fiscal–financial nexus of China's banking market transformation. It explains why most of China's local state banks appeared immediately after the 1994 fiscal recentralisation reform. Before 1998, local governments could veto the personnel appointments of the Big Four banks' local branch managers; premier Zhu brought this power to an end. Later, when Beijing sought to sever local government ties with the Big Four's local branches, it gave the local state banks even more privileges, such as the authority to build branches outside their own cities and provinces.

Political Competition and Market Expansion

Localities ran with Beijing's offer. But immediately on entering the banking business, they faced an existential crisis: how to compete with local Big Four branches, which already had a sweeping presence across the country by the mid-1990s. Despite this, the local state banks took off quickly. There were several factors behind their success, the most critical being local government support.

Local governments injected fiscal revenue into the new banks in the early years to get them going. They then coordinated with local state-owned enterprises and other government departments or work units to make enterprise deposits and set up payroll systems with the new banks. They also pressured wealthy local private businesses to borrow in advance, even when the firms had no need for funding, to beef up the banks' balance sheets. And they pushed local religious organisations — 'patriotic' churches and temples — to deposit their donations in the new banks.[3]

One reason local governments lend a strong helping hand is that they wish to have their cake and eat it, too. This is a rational choice for all local governments in China, as they need financial resources to outcompete their peers. This is also the whole point of the central–local

grand bargain: allowing localities sufficient financial wherewithal to grow and compete.

With strong local government support, the new banks aggressively expanded their turf and engaged in various market campaigns to grow their presence — for example, sending employees to residential compounds to sell bank products and services. Most importantly, they have been covertly raising deposit rates above central ceilings, such as handing out cash rewards proportional to the size of the customers' deposits and keeping these transactions on separate books.[4]

The local state banks have also borrowed from central policies to further expand their market reach. For example, during the administration of Hu Jintao and Wen Jiabao, a top central priority was rural development, with Beijing encouraging the formation of more rural financial institutions. Numerous local state banks (most of which were based in cities) seized the opportunity and applied for licences to set up village and township banks. The trick was that many localities in fact ended up situating these so-called village and township banks in urban areas to attract more customers; in recent years, they have also capitalised on fintech and collaborated with internet firms to reach potential customers nationwide. In some cases, the centre has lost track of what these banks are doing, as happened in Henan province, because village and township banks are usually not connected directly to the Central Clearing and Settlement System but only via the local state banks that created them.

The aim of local governments is not to monopolise local financial resources but to aggrandise them. For one thing, in their localities, they do not have the capacity to squeeze out the Big Four, which ordinary Chinese still view as the most stable financial institutions. More importantly, because local officials are like roving bandits who are transferred between localities every few years, they do not even bother trying to monopolise, because their successors can free-ride on their efforts.

That is why local governments have in fact played a crucial role in diversifying the local banking markets, by proactively inviting even more banks to enter their

jurisdictions. They benefit from this open-door policy in two ways. First, new entrants must usually sign deals with local governments that require them to make loans to designated local enterprises within a short period. Second, by reducing the Big Four's local market share, new entrants help boost 'local financial development', which is included in upper-level governments' evaluation criteria for local officials.

The rise of the local state banks unleashed ferocious competition in China's state-owned banking market, with the result that the Big Four are no longer dominant. Setting aside Tibet, for every Chinese province, 60–70 percent of banking assets and bank branches today are controlled by the local state banks. The city of Hangzhou, for example, had 671 bank branches and credit unions in 1990, but by 2015, this number had reached almost 5,000, only 38 percent of which belonged to the Big Four.[5]

So What?

What has the rise of local state banks meant for the Chinese economy? In short, it has created a state-owned banking market in which a variety of state agents are engaged in market competition, and the dynamism and dynamics of the markets change as the state's priorities shift. When the constraints of state control and command were loosened, banks in China competed as any commercial banks would, albeit within the bounds of the party-state. That said, things could change quickly now that Beijing decided to tighten its regulatory and policy grip.

In 2014, Nicolas Lardy's suggestively titled book *Markets Over Mao* debunked the myth that China's banking system continued to discriminate against private borrowers. In fact, thanks to the proliferation of smaller regional banks, Lardy argues, the banking system has become highly competitive, and that, in turn, has helped non-state borrowers.[6] Elsewhere, I have provided more systematic empirical evidence consistent with Lardy's conjecture.[7] But not all private borrowers are born equal or treated equally. It remains the case that politically connected firms have better access to bank loans and credit.

The most crucial outcome of intense bank competition has been an overconcentration of lending in

the real estate sector, particularly by local state banks. When the economy was still booming, it made sense for small, young banks to ride the rising housing tide — even embracing real estate firms as major shareholders to strengthen their balance sheets. It was the fastest way for the banks to expand. The downside of this expansion strategy, however, is now all too clear: the banks and real estate firms could sink together.[8] This is exactly what happened to the Shengjing Bank and the Evergrande real estate company, which was once the bank's biggest shareholder. As the real estate giant tottered, the bank also faltered and went through a radical restructuring to pre-empt a local banking crisis. More such events can be expected in the coming years.

Local governments encouraged this enmeshment between local state banks and real estate firms: they needed a booming housing sector to extract land rents, and they needed local state banks to grow so they could rely on them when fiscal problems arose, as happened during the 2008–2009 Global Financial Crisis. We know that China muddled through that disaster by pumping money into the economy. Far less known is that the local state banks together, through their LGFVs, provided even more funding to local governments than did the Big Four.

The Regulatory Dilemma

So where were the regulators? Why did they not check the wild expansion of local state banks, especially their excessively cosy relationship with the real estate sector? The answer hearkens back to the central–local grand bargain. As well as its concrete policy concessions, Beijing made clear it would not meddle with how localities raised and spent money. So, after the required taxes were submitted to the centre, all money-related matters could basically remain local 'secrets'.[9] And Beijing honoured its word.

This explains why, before Xi Jinping assumed power, China's banking regulators essentially focused on the Big Four and left the local state banks untouched. The pre-Xi era was one of 'great development', in the words of one regulator I interviewed. No-one really cared or dared to keep the local state banks in check. One municipal branch of the Banking Regulatory Commission tried in

vain to remove a local state bank president in a north-eastern province in the early 2000s, but the city government fought successfully to protect him.[10] Notably, local party secretaries and government bosses have proven much more powerful than the regulators.

After the stock market crash on 15 June 2015, President Xi did make a serious effort to ramp up regulatory pressure on the securities and banking markets. The number of punishments and warnings that central regulators issued to banks increased fifteenfold between 2012 and 2020, reaching 5,290 in the first year of the global pandemic. Yet, as growth decelerated, China–US relations worsened, and the self-destructive dynamic zero-COVID policy continued, Beijing backed down, and the number of bank punishments shrank dramatically to below 3,000 in 2021.

The Future

What will happen to Chinese banking? This is a crucial question for the world to ponder, because it matters not just to China's economy but also to the world's. Let us assume the CPC will remain in power. Now that Xi has relaxed his zero-COVID policy, and once the economy bounces back, we will see the return of significant regulatory pressure on the banks. There will be less intense competition among banks than before Xi took power. As the state strikes back, banks will again make more loans aligned with government policies, as they did in the early years of reform. The private sector will suffer as a result.

In the post-Xi era, presumably sometime after 2032, we might see the revival of a more dynamic state-owned banking market, but we should not expect any massive entry of private or foreign banks, as that would be inimical to party rule. Nor should we expect large waves of central or local state bank failures. Problematic banks will continue to be merged with others or acquired by the central government, as has always been the case. In this state-owned market made by the party, there will be no creative destruction, only creative reorganisation.

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